



**T. Hughes Reply Affidavit – Attachment A**

**IN THE UNITED STATES DISTRICT COURT  
FOR THE WESTERN DISTRICT OF MISSOURI  
WESTERN DIVISION**

<b>AT&amp;T COMMUNICATIONS OF THE SOUTHWEST, INC.,</b>	)	
	)	
	)	
<b>Plaintiff,</b>	)	
	)	
<b>vs.</b>	)	<b>Case No. 97-1573-CV-W-5</b>
	)	
<b>SOUTHWESTERN BELL TELEPHONE COMPANY, et al,</b>	)	<b>(Consolidated with Case Nos.</b>
	)	<b>97-4337-CV-W-5;</b>
	)	<b>98-0450-CV-W-5; and</b>
	)	<b>98-0501-CV-W-5)</b>
<b>Defendants.</b>	)	

**AT&T'S OPPOSITION TO SWBT'S MOTION FOR SUMMARY JUDGMENT**

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Plaintiff AT&T Communications of the Southwest, Inc. ("AT&T") respectfully submits this Response to the Motion for Summary Judgment of Southwestern Bell Telephone Company ("SWBT"). For the reasons stated below, the defendant's motion should be denied and judgment should be entered in favor of AT&T on all claims and counterclaims.

## **I. SWBT'S CONSTITUTIONAL CHALLENGES ARE BASELESS**

In its Brief, SWBT suggests that the Missouri PSC employed such slipshod procedures in arbitrating both the permanent pricing phase of the first arbitration and the second arbitration that the federal Constitution was violated.<sup>1</sup> When stripped of its rhetoric, SWBT's constitutional challenge boils down to a complaint that the PSC utilized a proceeding that did not have all the trappings of a civil trial. SWBT Brief at 18. What SWBT never contends, however, is that it was denied an opportunity to be heard. As explained below, SWBT clearly had that opportunity, and that is what the Constitution required.

### **A. Procedural History of Permanent Pricing Phase of the First Arbitration and the Second Arbitration**

#### **1. The Permanent Pricing Phase**

The PSC commenced the permanent pricing phase immediately after the conclusion of the first arbitration. In an Order dated January 22, 1997, the PSC modified and clarified its December 11, 1996 Arbitration Order and established the schedule for the development of permanent rates. January 22, 1997 Order at p. 8 (R. 1123). The PSC specifically noted that the first arbitration, in which the PSC established interim rates and which had been conducted under the time constraints imposed by the federal Telecommunications Act, had not permitted the detailed analysis necessary to establish permanent rates and that further proceedings were necessary. *Id.* at 8-9. What ensued was an intensive sixteen-week investigation conducted by

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<sup>1</sup> SWBT has apparently abandoned its claim below that the first arbitration also violated due process; indeed, SWBT now holds the first arbitration out in this appeal as a model.

members of Missouri PSC Staff ("Staff") focusing on "identifying the critical inputs and analyzing the costing models." Id. at 9. Staff was directed to meet with SWBT personnel 2-3 days each week in SWBT's offices "where software, data and subject matter experts responsible for critical input values will be readily available." Id. Because SWBT would be disclosing "extraordinarily confidential information," AT&T and MCI were not allowed to participate in those meetings. Id. Staff was also directed to meet with AT&T and MCI during this period to identify critical inputs and to analyze costing models which AT&T and MCI endorsed. SWBT was not allowed to participate in those meetings. The PSC designed this process to "allow the parties the opportunity to work with the Commission's advisory Staff to explain in a thorough, detailed and analytical fashion their costing models and final costing inputs." Id. The procedural schedule further contemplated that Staff would issue a proposed analysis which the Commission would use in setting proposed permanent rates. The parties would have the opportunity to comment prior to permanent rates being set. Id. at 9-10. The schedule targeted a date of June 30 for the issuance of permanent rates.

Because of the complexity of the issues being reviewed and the depth of information available, the PSC extended its deadline by 30 days to allow a complete and thorough review of all cost, pricing and rate issues. See June 9, 1997 Notice Regarding Schedule for Development of Permanent Rates. As a result of the months of meetings between Staff and various parties' subject matter experts, Staff was able to compile a Costing and Pricing Report which was several hundred pages long. On July 31, 1997, the Commission issued its Final Arbitration Order, which set permanent prices in accordance with Commission Staff's Costing and Pricing Report, a 189-page redacted version of which was attached to the Order itself. The PSC noted that the Costing and Pricing Report constituted a "thorough and exhaustive review of each and every cost

factor which the Commission finds relevant to this arbitration.” July 31, 1997 Final Arbitration Order at 3 (R. 1368). The PSC also recognized that because it had not issued proposed prices prior to issuing a final order, “in the interests of due process, the Commission will allow the parties twenty days to move for reconsideration or clarification.” *Id.* at 2. SWBT did indeed file a Motion for Reconsideration or Clarification, as well as two additional responsive pleadings. (R. Doc. #0006, 1447, 1461). On October 2, 1997, the PSC issued an Arbitration Order Regarding Motions for Clarification and Reconsideration and Joint Motion for Expedited Resolution of Issues, which granted SWBT’s Motion for Reconsideration in part. (R. Doc #0008).

## **2. The Second Arbitration**

AT&T filed its petition for a second compulsory arbitration on September 10, 1997. After negotiations between the parties, AT&T and SWBT filed a joint list of remaining issues on October 24, 1997. (R. 1713). The Joint Issues List contained 160 unresolved issues. On October 30, 1997, the PSC issued an Order adopting a Procedural Schedule for the Second Arbitration. (R. 1744). The Order specified that no hearing would be held in the case, and that the PSC would base its arbitration order on the pleadings filed in the case, as well as on any technical expertise provided by the PSC Staff. (R. 1744 at p. 7)

The parties prefiled direct testimony on November 7, 1997. SWBT and AT&T met during the period of November 10 through 20 with the Arbitration Advisory Staff (AAS) and with Commission General Counsel Dana K. Joyce, appointed by the Commission as a Special Master, for the purpose of resolving as many of the unresolved issues as possible. The parties then filed their Joint Settlement Document on November 21 which identified each of the issues from the Joint Issues List which had either been withdrawn or resolved by agreement by SWBT

and AT&T during mediation. (R. Doc. #00014). In accordance with the Commission's October 30 order, the Joint Settlement Document set forth the specific language agreed to by the parties for implementing their accord.

Also on November 21, the parties and the Special Master filed their Commission-ordered Joint Statement of Remaining Issues, which was amended by interlineation on November 24 and 25. (R. 1788, 1887, 1896). This Statement was replaced by an Amended Joint Statement of Remaining Issues on November 26. (R. Doc. #00015). The Amended Statement identified each of the unresolved issues from the Joint Issues List and, for each such issue, set forth 1) the language proposed by each party, 2) the Special Master's recommendations concerning which language to adopt, and 3) the Special Master's explanation of his recommendations. SWBT and AT&T each filed their responses to the Special Master's recommendations on November 26. (R. 1899, 1930). The PSC issued its Report and Order on December 23, 1997. (R. 1962).

#### **B. SWBT Fails to Demonstrate Any Due Process Violation**

SWBT alleges that the PSC violated its rights under the Due Process Clause, U.S. Const. amend. XIV, by failing to create a record, not receiving evidence, not allowing cross-examination and not holding a hearing. SWBT Br. at 18. SWBT, however, confuses the minimal requirements of procedural due process with its desire for a trial-type evidentiary hearing. In its zeal, SWBT ignores a well-developed body of case law that recognizes the flexibility of due process requirements in the administrative context.

The "essential requirements of due process" are notice and an opportunity to be heard. Cleveland Bd. of Educ. v. Loudermill, 470 U.S. 532, 546 (1985). "Whether [due process] requires that a particular right obtain in a specific proceeding depends upon a complexity of factors. The nature of the alleged right involved, the nature of the proceeding,

and the possible burden on that proceeding, are all considerations which must be taken into account.” Hannah v. Larche, 363 U.S. 420 (1960). “It is well-settled that procedural due process guarantees do not require full-blown, trial-type proceedings in all administrative determinations.” Kemira Fibres Oy v. U.S., 858 F.Supp. 229 (U.S.C.I.T. 1994). Indeed, administrative agency “hearings” in the context of economic regulation of businesses may satisfy the requirements of due process without *any* cross-examination or live proceedings whatsoever. See, e.g., United States v. Florida East Coast Ry. Co., 410 U.S. 224, 238, 242 (1973). “Due process does not necessarily require a trial-type hearing or an opportunity to confront and cross-examine. The fact is that the differences in the origin and function of administrative agencies preclude wholesale transplantation of the rules of procedure, trial, and review which have evolved from the history and experience of courts.” Pasco Terminals, Inc. v. United States, 83 Cust. Ct. 65, 477 F.Supp. 201 (1979), aff’d, 634 F.2d 610 (Cust. & Pat. App.1980). Thus, when administrative agencies conduct nonadjudicative fact-finding investigations, rights such as cross-examination generally do not obtain. *Id.*

SWBT’s Brief itself displays that SWBT had a full and fair opportunity to be heard. For example, in support of its claim that the PSC erred in refusing to allow SWBT to cross-examine witnesses, SWBT itself notes that “in resolving AT&T’s second arbitration request, the PSC allowed the parties to present only written, direct testimony to the Special Master.” SWBT Brief at 19. SWBT argues that this written opportunity to be heard was insufficient because it was entitled to cross-examine AT&T’s witnesses because “many of the issues involved complex factual and technical disputes.” *Id.* However, SWBT’s position is simply not supported by the law. A number of courts have held in administrative proceedings involving “complex and technical factual controversies, that written submissions, possibly

supplemented by oral argument. suffice.” Virgin Islands Hotel Association, Inc., v. Virgin Islands Water & Power Authority, 476 F.2d 1263 (3<sup>rd</sup> Cir.), cert. denied, 414 U.S. 1067 (1973) (citing United States v. Florida East Coast Railway Co., 410 U.S. 224 (1973); Phillips Petroleum Co. v. F.P.C., 475 F.2d 842 (10<sup>th</sup> Cir. 1973), cert. denied, 414 U.S. 1146 (1974); National Air Carriers Association v. CAB, 359 F.2d 624 (D.C. Cir.), cert. denied, 385 U.S. 843 (1966)).

Indeed, the D.C. Circuit has more recently addressed similar issues in a case involving FERC’s licensing of the Iroquios/Tennessee Project, a 370-mile pipeline extending from the Canadian border in upstate New York to Long Island and part of a billion dollar plan to ship natural gas from Alberta to the Northeastern United States. Louisiana Assoc. of Indep. Producers and Royalty Owners v. FERC, 958 F.2d 1101 (D.C. Cir. 1992). Opponents challenged the certification on the grounds that FERC reached its decision unfairly, improperly, and in violation of due process. Specifically, they claimed that they were prevented from conducting either discovery or cross-examination upon the assumptions underlying the evidence submitted by project supporters and relied upon by the Commission. Id. at 1113. The D.C. Circuit held that opponents

had ample opportunity to oppose the Project in written submissions and oral argument. In the Commission’s view, the only thing they lacked was a trial-type evidentiary hearing, but given the nature of the facts in dispute, there was no need for such a hearing. Trial-type proceedings . . . are necessary only when “a witness’ motive, intent, or credibility needs to be considered” or “where the issue involves a dispute over a past occurrence.”

Id. at 1113. Cross-examination is not necessary on “‘purely technical issues’ capable of being resolved not on the basis of a witness’ motive or memory, but rather upon an ‘analysis of the conflicting data and a reasoned judgment as to what the data shows.’” Id.

SWBT also argues that it has been deprived of due process because the PSC relied on extra-record evidence and has failed to place the basis for its decision in the record, thus precluding meaningful review. SWBT Br. at 21-22. However, even a cursory review of the August 12, 1998 filing of the Record on Appeal in this case indicates that a proper record exists here. The Record on Appeal consists of thousands of pages of testimony, exhibits, cost studies, written submissions and PSC Orders.

It is undisputed that SWBT had notice and ample opportunities to submit evidence and argument to the PSC below. During the second arbitration, the PSC conducted a week of presentations by the parties before the Special Master. These meetings allowed attorneys and subject matter experts (SMEs) for the parties to make presentations and respond to questions by the Special Master and Staff. While cross-examination was not allowed and the proceeding was not conducted on the record, the parties could respond to evidence and argument propounded by the other party. This week of presentations resulted in recommendations by the Special Master, which were relied on by the PSC in issuing its Report & Order. SWBT was given an opportunity to respond to the Recommendations of the Special master (R. 1899) prior to the PSC's issuance of the Report and Order. The permanent pricing phase of the first arbitration also provided SWBT with a meaningful opportunity to be heard. The PSC used SWBT's cost studies, with modifications, to arrive at permanent rates. Staff held weeks of meetings with SWBT's SMEs to gather information. SWBT was allowed to comment on the prices determined by the PSC prior to their taking effect. SWBT cannot seriously allege that it was given an inadequate opportunity to make its

case.<sup>2</sup>

At bottom, SWBT's due process claim is an amalgam of its assorted challenges to the Agreement recast as a constitutional deprivation. SWBT has failed to provide adequate support for those challenges individually, and it gains nothing by simply repeating them under the heading of due process. This Court should dismiss SWBT's due process claim.

**C. The PSC's Arbitration Process was not Arbitrary and Capricious**

SWBT's claim that the PSC's arbitration process was arbitrary and capricious is nothing more than a rehashing of its due process claims. SWBT contends that it was "arbitrary and capricious" for the PSC to deny SWBT a meaningful opportunity to be heard. SWBT Brief at 24. What is clear, however, from the above discussion of SWBT's due process claims, is that SWBT did indeed receive a meaningful opportunity to be heard. SWBT's quibbles with the manner in which the PSC chose to hear from SWBT and the other parties simply does not rise to the level of an arbitrary and capricious action.

SWBT also claims that the PSC failed to follow its own announced procedures. The procedures that SWBT identifies were established by the PSC for conducting the first arbitration between AT&T and SWBT, and those procedures were indeed followed. After the conclusion of the first arbitration, the PSC determined that it had not had sufficient opportunity to investigate and establish permanent rates, and established a further set of

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<sup>2</sup> SWBT claims that it was not allowed to present any evidence or argument on relevant issues. The only issue SWBT identifies is the question of pricing methodology. SWBT Br. at 20, 23. SWBT states that after the Eighth Circuit vacated the FCC's pricing rules on July 18, 1997, it was allowed one opportunity to address pricing methodology, and that the one opportunity was illusory. SWBT Br. at 20. What SWBT omits to mention, however, is that the FCC's pricing rules had been stayed nine months earlier on October 15, 1996, and were not in effect at the time the PSC conducted the first arbitration or the majority of the permanent pricing phase. See SWBT v. AT&T, No. A97-CA-132 SS, 1998 WL 657717 at \*1 (W.D. Tex. Aug. 31, 1998) (attached in Addendum). Despite the fact that the FCC pricing rules were not in effect, SWBT submitted testimony and its own cost models in support of such a methodology. See infra Part II.

procedures for conducting the permanent pricing phase. Given that the permanent pricing phase was a further elaboration of claims at issue in the first arbitration, the PSC was under no obligation to follow the previously established procedures. The only deviation from the procedures established for the permanent pricing phase was the PSC's decision not to issue proposed prices on which the parties could comment prior to issuance of an order. Instead, the PSC issued its Arbitration Order on July 31, 1997 and delayed its effectiveness until August 20, 1997 to allow the parties to comment on the permanent prices.

Finally, SWBT again attempts to argue that the failure to provide a complete evidentiary record was error, this time under the guise of arbitrary and capricious review. SWBT, however, misinterprets the cases on which it relies. As discussed above, an administrative record is different than an evidentiary record. The information that the PSC relied on in reaching its decision is indeed included in the administrative record as filed with this Court on appeal.

**D. The PSC Arbitration Process was not Required to Comply with State Law and Commission Regulations**

SWBT's final attack on the PSC's process is that it failed to comply with the Missouri Administrative Procedure Act (MAPA) and regulations. Such an inquiry, however, is simply irrelevant. This compulsory arbitration was not governed by Missouri law, but instead by federal law in the form of the Telecommunications Act of 1996. Congress established a unique process in section 252(b)—namely arbitration—that state Commissions were required to follow in resolving interconnection disputes. The arbitration procedure outlined by Congress does not fit neatly into rulemaking or adjudicative procedures outlined by state administrative law and regulations. The relevant inquiry is whether the PSC

properly implemented section 252(b), not whether it followed contested case procedures required by Missouri law.<sup>3</sup>

**II. THE PSC'S USE OF AN EFFICIENT FORWARD-LOOKING METHODOLOGY TO PRICE INTERCONNECTION AND NETWORK ELEMENTS IS NOT ONLY PERMITTED, BUT REQUIRED, BY THE ACT'S TEXT AND PURPOSE.**

**A. SWBT Advocated the use of a Forward-Looking Pricing Methodology before the PSC**

SWBT complains that "the PSC—without even considering SWBT's arguments in favor of an alternative approach—employed a 'forward-lookng' methodology akin to the 'TELRIC' model set forth in the FCC's now-vacated rules." SWBT Brief at 27. SWBT omits a crucial fact--the PSC used SWBT's costing model, with modifications as appropriate, in arriving at both interim and permanent rates. SWBT contended in the first arbitration that its cost studies reflected forward-looking costs, were consistent with the FCC's TELRIC methodology and should be used by the Commission. See, e.g., Direct Testimony of J. Michael Moore at 12 (Ex. 7). AT&T had propounded the Hatfield model. See Direct Testimony of Robert P. Flappan (Ex. 35). The PSC decided that it would use the SWBT studies, with adjustments, to set permanent rates. December 11, 1996 Arbitration Order at 6 (R. 951).

During the permanent pricing proceeding, SWBT's cost studies were again used. Despite the fact that the FCC's pricing rules were stayed on October 15, 1996 and thus were not in effect

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<sup>3</sup> Even if Missouri law were relevant to this inquiry, SWBT relies on inappropriate provisions of the MAPA. The provisions of MAPA and Missouri PSC regulations that SWBT cites all relate to **contested cases**. The compulsory arbitration between AT&T and SWBT does not fit into the category of a contested case, and the PSC was well within its discretion in crafting procedures used in rulemakings or other informal actions. See, e.g., St. Louis County v. State Tax Comm'n, 608 S.W.2d 413, 414 (Mo. banc 1980) (a contested case within the meaning of §536.100, R.S. Mo. does not mean every case in which there may be a contest about rights, duties or privileges, or every case in which a hearing is required).

throughout the first arbitration and the majority of the permanent pricing phase. see Southwestern Bell Telephone Co. v. AT&T Communications of the Southwest, Inc., No. A 97-CA-132 SS, 1998 WL 657717 at \*1 (W.D. Tex. Aug. 31, 1998),<sup>4</sup> SWBT continued to promote the use of its forward-looking cost studies until after the FCC's pricing rules were vacated July 18, 1997. SWBT's failure to timely contest the use of forward-looking costing methodology before the PSC should be fatal to its claims on appeal. See, e.g., GTE South, Inc. v. Morrison, 6 F.Supp.2d 517, 529 (E.D. Va. 1998) ("The administrative record reveals that GTE advocated a forward-looking measure of costs . . . . GTE has waived its right to argue for historical costs.").

**B. The PSC's Choice of Forward-Looking Pricing For Unbundled Elements Is Consistent With the 1996 Act.**

If this Court does choose to address SWBT's challenge to forward-looking pricing, it should recognize that the 1996 Act simply does not require that the rates new entrants pay SWBT for leasing unbundled network elements fully compensate SWBT for "all" of its excessive monopoly-era historical costs. Section 252(d)(1)'s requirement that rates be "based on the cost of providing" network elements plainly authorized the PSC to set rates based on forward-looking cost, rather than the grossly inflated historic costs on SWBT's books. Indeed, § 252(d)(1) is properly read as requiring a forward-looking cost methodology because that is the only result consistent with the text, structure, and purposes of the 1996 Act. As another federal district court has recently explained:

There can be little doubt that incremental, forward-looking costs mimic competitive costs – what it would cost efficient companies to enter and compete in a competitive local service market. In essence, the TELRIC

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<sup>4</sup> Copies of the principal unpublished decisions cited in this memorandum are contained in a separately bound Addendum, which is also being filed today.

methodology places everyone – the incumbent LEC and new entrants -- on a level playing field. Because the TELRIC methodology simulates competitive, as opposed to monopolistic, forces, it facilitates rapid entry into the local telephone service market and thereby serves the overriding and principal goal of the Act . . . For all of these reasons, it is apparent that the TELRIC methodology adopted by the PUC not only comports with the [Act], it is compelled by it.

SWBT v. AT&T, at \*13; see also MCI Telecomm. v. PacBell, No. C97-1756SI, slip. op. at 7 (N.D. Cal. Sept. 29, 1998) (“[T]he Court concludes that MCI is correct that the Act requires state commissions to use forward-looking pricing methodologies and precludes the recovery of historic costs.”) That is also the conclusion of the FCC,<sup>5</sup> every state commission to have considered the issue, and every federal district court that has ruled on the issue thus far.<sup>6</sup> This uniformity of result is hardly surprising, but it is “strong evidence supporting the reasonableness of the [PSC’s] actions.” SWBT v. AT&T, at \*10. SWBT’s reading of the 1996 Act is irreconcilable with not only a century of utility regulation practice but also (and more importantly) the 1996 Act’s goal of creating local competition “as quickly as possible.” H.Rep. at 89.

#### **1. The Text of the Act Requires Prices Based on Forward-Looking Costs.**

The language in § 252(d)(1) providing that rates must be “based on . . . cost” and “may include a reasonable profit” cannot plausibly be construed as an unyielding mandate for historic cost pricing. “[T]he meaning of statutory language, plain or not, depends on context.” King v.

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<sup>5</sup> Local Competition Order ¶ 679.

<sup>6</sup> See SWBT v. AT&T at \*10-13; GTE v. Morrison, 6 F. Supp.2d 517, 528 (E.D. Va. 1998); MCI Telecomm. v. PacBell at 7; MCI Metro Access Transmission v. GTE Northwest, Inc., No. C97-742 WD, slip op. at 7 (W.D. Wash. July 7, 1998); MCI Telecommunications Corp. v. U.S. West Communications, Inc., No. C97-1508R, slip op. at 17 (W.D. Wash. July 21, 1998); U.S. West Communications, Inc. v. AT&T Communications of the Pacific Northwest, Inc., No. C97-1320R, slip op. at 17-19 (W.D. Wash. July 21, 1998); U.S. West Communications Inc. v. TCG Seattle, No. C97-354 WD, slip op. at 5 (W.D. Wash. Jan. 26, 1998); AT&T Communications v. BellSouth Telecomms., No. 97-79, 1998 WL 688241 at \*3 (E.D. Ky Sept. 9, 1998).

St. Vincent's Hospital, 502 U.S. 215, 221 (1991). SWBT purports to rely on the "ordinary meaning" of the word "cost," but in this context "cost" simply does not have a single, ordinary meaning. As the Fourth Circuit has explained, "where Congress uses technical words, or terms of art, those words are to be construed by reference to the art or science involved." Media General Cable of Fairfax, Inc. v. Sequovah Condominium Council of Co-Owners, 991 F.2d 1169, 1173 (4<sup>th</sup> Cir. 1993); see also, McDermott Int'l. Inc. v. Wilander, 498 U.S. 337, 342 (1991); Corning Glass Works v. Brennan, 417 U.S. 188, 201 (1974). In the context of utilities regulation, "cost" is just such a term of art – it is "an inexact standard," susceptible of at least two different interpretations – historic cost or forward-looking cost. Alabama Elec. Coop v. FERC, 684 F.2d 20, 27 (D.C. Cir. 1982); see also James C. Bonbright et al., Principles of Public Utility Rates, 109 (2d ed. 1985).

Thus, courts have routinely upheld measures of "costs" that are forward-looking. See, e.g., Illinois Bell Tel. Co. v. FCC, 988 F.2d 1254, 1263-64 (D.C. Cir. 1993); Natural Gas Pipeline Co. of America v. FERC, 765 F.2d 1155, 1157, 1163-64 (D.C. Cir. 1985), cert. denied, 474 U.S. 1056 (1986). Even the phrase "actual costs," the D.C. Circuit recently held, does not compel an historical cost method. City of Los Angeles Dep't of Airports v. United States Dep't of Transp., 103 F.3d 1027, 1032 (D.C. Cir. 1997). This is because the term "cost" does not "prescribe[] an accounting" (i.e., embedded or "book value") "rather than an economic" (i.e., forward looking) conception of cost. Id.; see also MCI Communications Corp. v. American Tel. & Tel. Co., 708 F.2d 1081, 1118 n.52 (7<sup>th</sup> Cir. 1982) (noting that the term "average total cost" is understood by experts to "mean average total economic costs, i.e., costs on a forward-looking basis"), cert. denied, 464 U.S. 891 (1983). SWBT's argument that cost can only mean embedded

cost is simply wrong.<sup>7</sup>

Other provisions in the Communications Act make clear that when Congress intends to mandate an *historic* cost methodology, it does so expressly. Section 224(d), for example, provides that pole attachment rates may not exceed “the sum of operating expenses and actual capital costs of the utility.” 47 U.S.C. § 224(d) (emphasis added); see also id. § 543(b)(3) (price of certain cable equipment to be established on the basis of “actual cost” of installation and leasing) (emphasis added). It is standard practice to interpret statutes by comparison with other statutes *in pari materia*, even if the other statutes are not contained in the same legislative enactment. See, e.g., Securities Indus. Ass’n v. Board of Governors, 807 F.2d 1052, 1063 (D.C. Cir. 1986) (examining other securities acts to aid interpretation of term in Glass-Steagall Act). Here, there is ample reason to do so because the 1996 Act expressly amended the Communications Act, including § 224 itself. See Conf. Rep. at 117.

The full text of section 252(d)(1)(A) -- which requires that prices be “based on the cost (determined without reference to a rate-of-return or other rate-based proceeding) of providing the interconnection or network element” -- further supports the PSC’s interpretation. Economics teaches that the cost “of providing” a commodity today is the forward-looking incremental cost of “producing” it, not some backward-looking measure of sunk or historic costs. Alfred E. Kahn, Vol. 1 The Economics of Regulation: Principles and Institutions 65 (reprinted 1988). Production

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<sup>7</sup> That forward-looking pricing is permissible under the Act is further demonstrated by the Act’s command that rates for unbundled elements be “just and reasonable.” See §§ 251(c)(2)-(3), 252(d)(1). In 1944, the Supreme Court held that a statutory provision mandating that rates for unbundled elements be “just and reasonable” does not require any particular measure of cost. Federal Power Comm’n v. Hope Natural Gas Co., 320 U.S. 591 (1943). In view of this history, the text of the statute cannot plausibly be read to mandate “just and reasonable” rates based on historic costs. See Giles Lowery Stockyards, Inc. v. Department of Agric., 565 F.2d 321, 323-24 (5<sup>th</sup> Cir. 1977) (citation omitted), cert. denied, 436 U.S. 957 (1978).

costs necessarily "look to the future, not to the past: it is only future costs for which additional production can be causally responsible." Kahn, supra at 88. A forward-looking methodology is also most consistent with the Act's prohibition on rate-of-return or other rate-based proceeding[s]." 47 U.S.C. 252(d)(1)(A)(i). Historic costs are invariably determined in a rate-of-return proceeding. See Illinois Bell Tel. Co. v. Few, 988 F.2d 1254, 1258-59 (D.C. Cir. 1993). Thus, the historic cost methodology SWBT wants to force on the PSC necessarily would embroil the PSC in a rate-of-return proceeding. See GTE v. Morrison, 6 F. Supp.2d 517, 529 (E.D. Va. 1993). Indeed, it would be strange to interpret this provision as requiring historic costs given that Congress patterned §§ 251 and 252 on the efforts of progressive states that had adopted market-opening measures which used forward-looking cost methods. See Local Competition Order para. 631 & n. 1508; S. Rep. No. 104-230 at 5

SWBT's argument that the use of historic costs is mandated because the Act allows rates to include "a reasonable profit" is likewise meritless. SWBT Brief at 28; 47 U.S.C. § 252(d)(1)(B). To begin with, § 252 provides that prices "may include" profit. "[T]he word 'may' in a statute normally confers a discretionary power, not a mandatory power." Apex Plumbing Supply, Inc. v. U.S. Supply Co., 142 F.3d 188, 192 (4<sup>th</sup> Cir. 1998), cert. denied, 119 S.Ct. 178 (1998). Thus, rates would be consistent with the statute even if they allowed SWBT no profit.

In any event, prices based on long-run incremental costs do allow incumbents to earn a reasonable profit. As the FCC explained, "[t]he concept of normal profit is embodied in forward-looking costs because the forward-looking cost of capital, i.e., the cost of obtaining debt and equity financing, is one of the forward-looking costs of providing the network elements." Local Competition Order ¶ 700; see also Burlington Northern R.R. Co. v. Surface Transp. Bd.,

114 F.3d 206, 212-14 (D.C. Cir. 1997) (rejecting claims that rates based on forward-looking costs of “hypothetical stand-alone” railroad were “conceptually flawed” and noting that such approach provides “a competitive return on all investments the railroad actually made at their current value”); Edwin Mansfield, Microeconomics 252-53 (6<sup>th</sup> ed. 1988) (‘economic’ profits in excess of forward-looking costs are not normal in a competitive market). As a district court recently concluded, “while there is no doubt that [an incumbent] would realize [far] greater profits if it were allowed to continue to recover monopolistic profits, that is not to say that a competitive market cannot yield ‘reasonable’ profits, which is all that is required by the plain language of the Act.” SWBT v. AT&T, 1998 WL 657717, at \*11.

Indeed, prices based on historic costs would violate the Act’s requirement that any profit must be reasonable. SWBT has defined “profits” to mean an amount above actual historical costs, and by that definition no profit is possible unless all historical costs have been covered. But that is simply not a plausible reading of the statute. Not even traditional rate-of-return schemes guarantee firms a profit in this sense. To the contrary, profits can be earned only on prudently incurred costs. Indeed, in SWBT’s view, § 252(d)(1) would do what no other ratemaking statute has ever done: guarantee SWBT a profit no matter how excessive or imprudent its investments. The requirement that any profit included be “reasonable” thus makes clear that SWBT has no conceivable right to recover the “creamy returns” it demands. Farmers Union Central Exchange, Inc. v. FERC, 734 F. 2d 1486, 1503 (D.C. Cir. 1984), cert. denied, 469 U.S. 1034 (1984).

## **2. The Act’s Purposes Mandate Forward-Looking Costs.**

A forward-looking cost methodology is the only measure of cost that gives effect to the Act’s goal of bringing the benefits of competition to consumers “as quickly as possible.” H.

Rep. at 89. As the Eighth Circuit explained, the very point of allowing new entrants to compete using unbundled parts of the existing network is "to expedite the introduction of pervasive competition" before full fledged competitive networks are built and operating. Iowa Utils. Bd. v. Federal Communications Comm'n, 120 F.3d 753, 816 (8<sup>th</sup> Cir. 1997) (emphasis added), cert. granted sub nom., AT&T Corp. v. Iowa Utils. Bd., 118 S.Ct. 879 (1998). Thus, § 252(d)(1) is properly read as requiring a forward-looking cost methodology. See generally King v. St. Vincent's Hospital, 502 U.S. at 221 n.10 (affirming the "cardinal rule" of statutory construction "that a statute is to be read as a whole," because courts must "adopt that sense of words which best harmonizes with context and promotes [the] policy and objectives of [the] legislature").

A forward-looking pricing methodology is the only choice consistent with that objective because it is the only choice that will result in retail rates comparable to those that would prevail under conditions of competition. As a federal district court recently explained (in rejecting a challenge identical to the one here), "[F]orward-looking methodologies like TELRIC are relevant to competitive markets, as opposed to monopolies, because it sets prices based upon what it would cost new entrants to provide the desired elements within a competitive market." SWBT v. AT&T, 1998 WL 657717, at \*10; see also Potomac Elec. Power Co. v. ICC, 744 F.2d 185, 189 (D.C. Cir. 1984) (forward-looking prices are a "surrogate" for competition in industry where competition itself has not yet taken root). If a new entrant's costs are set at efficient levels, the new entrant can charge a retail price that would prevail in a fully competitive market. By contrast, if a new entrant must pay the full historic cost of network elements, it cannot price retail services at the level that would prevail in competitive conditions, and consumers will not reap the benefits of competition. Use of an embedded cost methodology would simply perpetuate SWBT's monopoly rate-of-return prices -- thereby maintaining the status quo Congress sought

to change.

Prices based on forward-looking costs also "give appropriate signals to producers and consumers to ensure efficient entry and utilization of the telecommunications infrastructure." In re Interconnection Between Local Exchange Carriers & Commercial Mobile Radio Serv. Providers, Notice of Proposed Rulemaking, 11 F.C.C.R. 5020 ¶ 47 (1996). In sharp contrast to forward-looking rates which "give[] utilities strong incentive[s] to manage their affairs well and to provide efficient service to the public," Duquesne Light Co. v. Barasch, 488 U.S. 299, 309 (1989), an historic cost approach would give incumbents incentives to "operate inefficiently," "pad" their rates with monopoly profits, and "adopt the most costly, rather than most efficient, investment strategies." In re Policy & Rules Concerning Rates for Dominant Carriers, Further Notice of Proposed Rulemaking, 3 F.C.C.R. 3195 ¶39 (1988).

Moreover, an embedded cost method could preclude meaningful competition from ever developing. Because use of an embedded cost methodology would allow SWBT to write off its obsolete investment while simultaneously charging new entrants rates based on its inefficient infrastructure, SWBT could undercut new competitors' prices in the short term in an attempt to retain its monopolistic grip on the market. See Town of Concord v. Boston Edison Co., 915 F.2d 17, 18-19 (1<sup>st</sup> Cir. 1990) (Breyer, J.), cert. denied, 499 U.S. 931 (1991); United States v. Aluminum Co. of America, 148 F.2d 416, 437-38 (2d Cir. 1945) (Hand, J.). Forward-looking pricing prevents this: "In essence, the TELRIC methodology places everyone – the incumbent LEC and new entrants -- on a level playing field." SWBT v. AT&T, 1998 WL 657717, at \*13.

SWBT attempts to respond to these arguments by asserting that forward-looking pricing stifles incentives for AT&T and other new entrants "to incur the expense or take the risk of building facilities of their own," SWBT Br. at 31, but that assertion is baseless. New entrants

have ample incentives to invest in their own facilities, and are in fact doing so.

First, a carrier purchasing elements at perfect forward-looking rates would still have an overriding reason to build its own facilities: no rational company would pursue a business strategy that depends on the long-term cooperation of its principle rival. As both a monopoly supplier to and a direct competitor of new entrants, SWBT has both “the incentive and the ability to engage in many kinds of discrimination. For example, [it] could potentially delay providing access to unbundled network elements, or . . . provide them to new entrants at a degraded level of quality.” Local Competition Order ¶ 307. “[I]ndependence from the incumbent” is thus a powerful incentive for new entrants to build and operate their own networks. SWBT v. AT&T at \*11.

Second, new entrants will want to be “first to market” with new technologies that permit better and more innovative service to consumers. The more new entrants rely on incumbents, the less possibility they have of ever gaining the competitive edge of being the first to innovate.

Third, new entrants have financial incentives to build their own facilities. To use an incumbent’s facilities, new entrants must incur costs associated with the physical process of ordering, obtaining, and maintaining the elements it leases from incumbents, as well as receiving, monitoring and paying the bills generated by the incumbent for use of network elements. Moreover, new entrants who rely on their competitor must face additional costs associated with attempting to prevent the non-price discrimination identified by the FCC, such as devising systems that allow the incumbent’s performance to be adequately monitored, retaining personnel to monitor the incumbent’s performance and, when necessary, pursuing remedial action. A new entrant will want to eliminate those costs by building its own network as fast as it reasonably can.

Fourth, the forward-looking methodology adopted by the PSC contains a built-in incentive for new entrants to build their own facilities. This is because the particular model used by the PSC uses an approach that takes into account SWBT's existing infrastructure, as opposed to an idealized network. See, e.g., July 31, 1997 Arbitration Order, Attachment C at 119 (R. 1368). Thus, a certain degree of inefficiency is built into the prices adopted by the PSC. As one court has explained, "[B]ecause the TELRIC methodology adopted by the [PSC] does not assume a perfectly efficient network," new entrants have a further "incentive to build their own facilities." SWBT v. AT&T, 1998 WL 657717, at \*11; see also Local Competition Order ¶ 685 (recognizing that assuming the existence of current central office locations "encourages facilities-based competition to the extent that new entrants, by designing more efficient network configurations, are able to provide the service at a lower cost than the incumbent LEC").

In sum, long-run incremental pricing is the only pricing methodology that complies both with the Act's plain language and with its purposes. This court therefore should reject SWBT's claim that the Act requires prices based on SWBT's historic costs. Of course, to reject SWBT's appeal of this issue, this Court need only conclude that the long-run incremental pricing methodology adopted by the PSC was permissible under the Act's terms and purposes. For SWBT to prevail, the Act must require recovery of historic costs. It does not.

### **C. The Takings Clause Does Not Require Historic Cost Pricing**

Because SWBT's statutory construction arguments cannot carry the day on their own terms, SWBT contends that they must be accepted to avoid a possible violation of the Takings Clause of the Fifth Amendment. That argument should be rejected.

To begin with, construction of a statute to avoid takings concerns is only proper in the "identifiable class of cases in which application of a statute will necessarily constitute a

taking.” United States v. Riverside Bayview Homes, Inc., 474 U.S. 121, 129 (1985) (emphasis added). SWBT has not even attempted to prove that a taking will necessarily result from the PSC’s pricing methodology. Absent such a showing, “adopting of a narrowing construction does not constitute avoidance of a constitutional difficulty; it merely frustrates permissible applications of a statute or regulation.” Railway Labor Executives Ass’n v. United States, 987 F.2d 806, 816 (D.C. Cir. 1993) (quoting Riverside Bayview Homes, 474 U.S. at 128).

In any event, SWBT’s takings argument rests on a proposition that the Supreme Court has consistently repudiated for 50 years—namely, that the Fifth Amendment requires rate-setting bodies to adopt a specific rate methodology. The takings clause does not bind rate-setting bodies “to the use of any single formula or combination of formulae in determining rates.” Federal Power Comm’n v. Hope Natural Gas Co., 320 U.S. 591, 602 (1944); accord Duquesne, 488 U.S. at 314; Wisconsin v. Federal Power Comm’n, 373 U.S. 294 (1963). It is the “impact of the rate order which counts.” See Hope Natural Gas, 320 U.S. at 602. A regulatory scheme works a taking only if it produces overall rates so low as to “jeopardize the financial integrity of the [regulated] companies. either by leaving them insufficient operating capital or by impeding their ability to raise future capital.” Duquesne, 488 U.S. at 312; accord SWBT v. AT&T at 11 (the relevant question is whether the rates are “confiscatory”). Thus, SWBT would have to demonstrate that the regulatory regime under which it is operating threatens it with “the sort of deep financial hardship described in Hope.” Jersey Cent. Power & Light Co. v. FERC, 810 F.2d 1168, 1181 n.3 (D.C. Cir. 1987) (en banc); accord Duquesne, 488 U.S. at 314. SWBT does not even attempt to meet that “heavy burden.” See Hope Natural Gas, 320 U.S. at 602.

SWBT devotes considerable effort to arguing that, notwithstanding the above authorities, a rate methodology “expressly designed to deprive a regulated entity of any recovery of actual cost could [not] withstand scrutiny” and that the “impact” test of Hope does not apply. SWBT Brief at 34. These arguments fail.

Rate methodologies that do not provide full compensation for historic costs routinely pass constitutional muster. In Duquesne itself, the Supreme Court upheld a state regulatory body’s decision to shift, in part, from a historic cost method to a fair value method, which resulted in denying the regulated utility recovery of tens of millions of dollars of prudently incurred historic costs on its books. 488 U.S. at 312-14; accord Illinois Bell Tel. Co. v. FCC, 988 F.2d 1254, 1263-64 (D.C. Cir. 1993) (rejecting a takings challenge to a rate order that served to “exclude part of [an] original investment from the rate base” because there is no obligation “to include in the rate base all actual costs for investments prudent when made,” and affirming that the relevant test remains whether “the FCC’s rate base policy threatens the financial integrity of [ILECs] or otherwise impedes their ability to attract capital”); Illinois Bell Tel. Co. v. FCC, 911 F.2d 776, 779-80 (D.C. Cir. 1990); Natural Gas Pipeline Co. of America, 765 F.2d 1157, 1163-64 (D.C. Cir. 1985), cert. denied, 474 U.S. 1056 (1986); see also Market St. Ry. Co. v. Railroad Comm’n, 324 U.S. 548, 567 (1945) (Constitution does not require basing “rates on the present reproduction value of something no one would presently want to reproduce, or on the historical valuation of a property whose history and current financial statements showed the value no longer to exist, or an investment after it has vanished, even if once prudently made.”).

Even if it were appropriate to examine the PSC’s ratemaking methodology on a “piecemeal” basis, see Duquesne, 488 U.S. at 313, SWBT’s takings concern is unfounded.

Had the government condemned SWBT's existing network, rather than requiring SWBT to lease parts of it, SWBT would be entitled to no more than "fair market value" of the property taken, which is the price a willing buyer would pay a willing seller for that property. United States v. Miller, 317 U.S. 369, 374 (1943). The fair market value of the existing network plainly cannot exceed the price of a new network which performs the same functions, because no buyer would pay more for used equipment than for new equipment capable of doing the same thing. Accord Reilly, supra at 48 ("Replacement cost new typically establishes the maximum amount that a prudent investor would pay for a technology.") Thus, network element rates calculated on the basis of the efficient replacement cost of the existing network raise no constitutional concerns. See United States v. 564.54 Acres of Land, 441 U.S. 506 (1979) (affirming compensation based on fair market value of \$740,000 and rejecting argument that the asserted replacement cost of \$5.8 million was constitutionally required, because the Takings Clause does not require payment of higher cost than fair market value of the property taken).

In the final analysis, SWBT is not really advancing a takings argument at all. The gravamen of SWBT's argument is that the 1996 Act is unfair because SWBT incurred costs on the assumption that it would be able to recover those costs through rate-of-return methods. See SWBT Brief at 33. But neither SWBT nor its investors could reasonably have assumed that SWBT would be allowed to remain a monopoly forever, or to maintain a regulatory regime in which SWBT recouped all of its actual costs. The Supreme Court has made abundantly clear that:

[w]hether competition between utilities shall be prohibited, regulated or forbidden is a matter of state policy. That policy is subject to alteration at the will of the legislature. The declaration of a specific policy creates no vested

right to its maintenance in utilities then engaged in the business or thereafter embarking in it.

Tennessee Electric Power Co. v. Tennessee Valley Authority, 306 U.S. 118, 141 (1939). The grant of an exclusive franchise does not guarantee a monopoly in perpetuity. Nor does the existence of a given regulatory scheme create any suggestion that the state will maintain that regime. See, e.g., Duquesne, 488 U.S. at 301. Because SWBT's takings concerns are without merit, the Court should affirm the PSC's use of a forward-looking pricing methodology.

**D. The PSC's Adjustments to SWBT's Proposed Rates were not Arbitrary and Capricious**

In addition to its global challenge to the rates adopted by the PSC, SWBT also claims that several of the specific adjustments that the PSC made to SWBT's proposed rates were arbitrary. SWBT's specific challenges are as flawed as its global challenge.

SWBT first challenges the PSC's decision to "arbitrarily exclude" fifty percent of the non-recurring costs (NRCs) for unbundled network elements. SWBT Br. at 35. In support of that argument, SWBT claims only that its proposed NRCs were developed using input from subject-matter experts (SMEs) "intimately familiar" with the work requirements necessary to the provision of unbundled elements. Id. SWBT attempts to frame the PSC's ruling as arbitrary and capricious by reducing Staff's recommendation to a decision that prices should be cut to promote competition and that neither party had met its burden of proof.<sup>8</sup>

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<sup>8</sup> SWBT also complains obliquely that the PSC provided no rationale for its decision. SWBT's complaint is belied by an examination of the record. The PSC's decision on rates is reflected in an Arbitration Order dated July 31, 1997. That Order states that "in light of the extensive review and analysis by the Commission's Advisory Staff (see Attachment C), certain modifications should be made to the interim rates previously ordered for unbundled network elements (UNEs)." Arbitration Order at 3-4 (R. 1368). Attachment C consists of a 189 page "Costing and Pricing Report" issued by the Missouri Staff.

Contrary to the representations by SWBT in its Brief, Staff gave reasoned decisions based on the evidence presented to it in justifying its decision to cut NRCs. Staff noted that SWBT estimates of labor time were based solely upon estimates provided by its employees, and were not supported by time and motion studies; a portion of the labor costs included in the NRCs were double-recovered because they were also reflected in SWBT's labor factors; and that large NRCs --which only new entrants would pay and from which SWBT will be exempt-- posed a substantial barrier to entry. July 31, 1997 Arbitration Order, Attachment C at p. 121 (R. 1368). Staff concluded that "[g]iven that SWBT's estimation of these NRCs is based solely upon the opinions of SME's [subject matter experts] and the fact that at least a portion of these NRCs are recovered through the cost factors applied to the UNEs, Staff cannot recommend that the Commission accept the NRCs proposed by SWBT." *Id.* at 123. That conclusion was amply supported by record evidence. AT&T had introduced evidence that all of the costs associated with SWBT's proposed NRCs were already reflected in the monthly UNE rates and that there should be no NRCs. *Id.* Staff also rejected adopting the NRCs proposed by AT&T in toto. *Id.* Given the significant discrepancies between AT&T and SWBT as to the efficient amount of time required to perform NRC functions, Staff's recommendation to reduce NRCs by 50% from SWBT's proposals, which was subsequently adopted by the PSC, far from being arbitrary and capricious, constitutes a reasonable policy determination supported by the administrative record.

SWBT next contends that the PSC improperly excluded inflation from SWBT's pricing model. SWBT Brief at p. 36. The PSC did not, however, decide to exclude inflation in a vacuum. As SWBT noted, Staff did recognize that "inflation reflects the changes in material and labor costs over time," but concluded that because of that "it seems only reasonable to include a productivity factor which reflects changes in the efficiency of labor and material utilization."

July 31, 1997 Arbitration Order, Attachment C at 118 (R. 1368). AT&T clearly demonstrated that SWBT's models failed to account for expected productivity gains. Staff was "concerned with the use of inflation without the use of productivity factors." *Id.* at 117. Staff concluded that "[I]f both an inflation factors and a productivity factor were included in the studies, the net result would almost zero." *Id.* at 118. Accordingly, Staff recommended that neither be included. *Id.* at 119. Staff specifically addressed and rejected SWBT's contention that a productivity factor was not appropriate "because the TELRIC model automatically assumes the use of the newest and most efficient technology available." *Id.* at 119. Staff noted that the operating and maintenance expenses included in SWBT's studies were based upon "historic data from the current network and are not technology specific"; accordingly they would not reflect productivity gains associated with the new forward-looking technology. *Id.* Far from being arbitrary, Staff's recommendation, and the PSC's subsequent decision, were well-reasoned and supported by the record. A Texas federal court has recently held that the Texas PUC's similar determination that "future productivity would exceed the impact of inflation is supported by the record and is not arbitrary and capricious." *SWBT v. AT&T*, 1998 WL 657717, at \*13.

Finally, SWBT raises a general issue regarding common costs. In reviewing this vague claim, it should be kept in mind that Staff adopted SWBT's proposed common cost allocator. SWBT's attack on common costs constitutes a backhanded critique of Staff's other decisions in establishing rates. SWBT's complaint is that Staff should have increased the common cost allocator because "Staff removed many cost items from the rates for specific elements." SWBT Brief at p. 36. SWBT fails, however, to identify any specific cost item that Staff inappropriately removed from the rates for specific elements. Without such a showing, SWBT's claim must fail.